No. 7002.

IN THE

United States
Circuit Court of Appeals,
FOR THE NINTH CIRCUIT.

Thomas A. O'Donnell,
Petitioner,

vs.

Commissioner of Internal Revenue,
Respondent.

BRIEF OF PETITIONER.

THOMAS R. DEMPSEY,
A. CALDER MACKAY,
1104 Pacific Mutual Building, Los Angeles, California.
Attorneys for Petitioner.

Parker, Stone & Baird Co., Law Printers, Los Angeles.

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HISTORY AND PREVIOUS OPINION.

The Commissioner of Internal Revenue, Respondent herein, on the 7th day of January, 1928, mailed to Petitioner, Thomas A. O'Donnell, hereinafter sometimes referred to as Taxpayer, what is termed a deficiency letter wherein the Commissioner proposed additional taxes for the year 1923 in the sum of $2,201.69. Within the sixty day period Petitioner filed his appeal with the United States Board of Tax Appeals wherein he alleged, among other things, that the inclusion of income by the Respondent in the sum of $16,023.51, which gave rise to the asserted deficiency in tax by the Respondent, was erroneous and illegal.

On the date of the hearing the Respondent confessed error in including the sum of $16,023.51 in Petitioner's net taxable income, but at the same time filed his second amended answer wherein he alleged that Petitioner's net taxable income should be increased by the sum of $114,908.31 by virtue of the receipt thereof by the Security Trust and Savings Bank as trustee under two trusts created by Taxpayer designated as Nos. 5106 and 5549.

The Rules of Practice of the Board of Tax Appeals specifically place the burden of proof upon the Respondent in those cases wherein he makes affirmative allegations tending to increase the deficiency. This, in any event, would be so since the Commissioner becomes a party litigant. The Respondent, in support of his contention that the sum of $114,908.31 constituted taxable income to Petitioner, alleged that the fair market value of the rights acquired by Petitioner by virtue of the contract with Petroleum Midway Company, Ltd., dated January 9, 1918, did not exceed the sum of $75,000.00. No oral testimony was presented by the Respondent to substantiate his allegations of value, the Respondent's entire case having been presented to the Board on a stipulation of facts.

The Board of Tax Appeals, among other things, held that the transaction of January 9, 1918, by the terms of which Petitioner transferred to Petroleum Midway Company, Ltd., certain stocks and options in consideration of his contractual rights to receive one-third of the future profits derived from the oil properties acquired by San Gabriel Petroleum Company, was a sale of property which "might or might not give rise to income dependent on the inscrutable factor of future oil production" and

held that "the promise to pay one-third of future profits was not equivalent to cash nor did it have, on January 9, 1918, an ascertainable fair market value". However, the Board endeavored to establish the cost or value "whichever is the appropriate base" of Petitioner's stock and options at the dates of their acquisition. Petitioner's options were acquired in December of 1917 and his stock was acquired on June 28, 1917. The stock of Petitioner had been acquired by him on June 28, 1917, in exchange for certain oil leases which had been acquired in March, 1917. The Board held that it was impossible on the record to determine exactly the fair market value of Petitioner's stock on this date, but, nevertheless, that the entire sum received by the Security Trust and Savings Bank under the two aforementioned trusts constituted taxable income to Petitioner.

JURISDICTION.

Thomas A. O'Donnell was and is a resident of the County of Los Angeles, State of California, and as such filed his income tax return with the Collector of Internal Revenue for the Sixth Collection District of the State of California. [R. p. 4.]

The decision of the United States Board of Tax Appeals was promulgated on March 23, 1932, and the final order of redetermination was entered on June 17, 1932. [R. p. 37.]

Petitioner filed his petition for review by this Honorable Court with the Clerk of the United States Board of Tax Appeals on July 28, 1932. [R. p. 48.] This appeal was taken pursuant to the provisions of Sections

1001, 1002 and 1003 of the Act of Congress approved February 26, 1926, entitled the "Revenue Act of 1926" (44 Stat. 1, 109, 110; U. S. C. A., Sections 1224, 1225, 1226), as amended by Section 603 of the Act of Congress approved May 29, 1928, entitled "The Revenue Act of 1928" (45 Stat. 873), and as further amended by Section 1101 of the Act of Congress approved June 6, 1932, entitled the "Revenue Act of 1932" (47 Stat. 286).

QUESTIONS INVOLVED.

I.

THE PROCEEDS DERIVED BY THE SECURITY TRUST AND SAVINGS BANK AS TRUSTEE UNDER TRUSTS NOS. 5106 AND 5549 PURSUANT TO THE CONTRACT OF JANUARY 9, 1918, DO NOT CONSTITUTE TAXABLE INCOME TO PETITIONER.

II.

THE ISSUE DECIDED BY THE BOARD WAS NOT RAISED BY THE PLEADINGS AND THE FACTS IN THE RECORD DO NOT SUPPORT THE BOARD'S DECISION THAT THE MONEYS RECEIVED BY THE TRUSTEE CONSTITUTE TAXABLE INCOME TO PETITIONER.

STATUTES INVOLVED.

See Appendix pages 37-39.

STATEMENT OF FACTS.

The Respondent, on January 7, 1928, determined a deficiency in tax against Petitioner in the sum of $2,201.69 from which Petitioner appealed. The additional tax arose because the Respondent included in Petitioner's net tax-

able income the sum of $16,023.51. At the date of the trial Respondent admitted that he had erroneously included said sum in Petitioner's net taxable income, but at the same time Respondent filed his second amended answer wherein he affirmatively alleged that Petitioner had erroneously failed to include in his income tax return as taxable income the sum of $114,908.31 received by the Security Trust and Savings Bank as trustee under the two aforementioned trusts. The Respondent's affirmative answer was based entirely upon the theory that the fair market value of the rights acquired by Petitioner by virtue of a contract entered into between the Petroleum Midway Company, Ltd., and Petitioner on January 9, 1918, did not exceed the sum of $75,000.00 and that all sums in excess of this amount constituted taxable income.

The Rules of Practice of the Board of Tax Appeals place the burden of proof upon the Respondent in those cases where he makes affirmative allegations.

No oral testimony was offered by Respondent to support his affirmative allegations and the only evidence offered was a stipulation of facts which is substantially as follows:

> During March, 1917, Thomas A. O'Donnell, Petitioner herein, M. L. McCray and L. A. McCray acquired for a nominal consideration certain oil and gas leases which on June 28, 1917, were transferred and assigned to the San Gabriel Petroleum Company in exchange for its outstanding capital stock. Each one of the foregoing persons received one-third of such stock.
>
> On December 24, 1917, and December 31, 1917, respectively, Petitioner acquired certain options to

purchase all of the said capital stock of the San Gabriel Petroleum Company owned by M. L. McCray and L. A. McCray. Thereafter Petitioner assigned all of his right, title and interest in and to all the options hereinbefore mentioned and also all of his right, title and interest in and to the stock owned by him in the San Gabriel Petroleum Company, being one-third of the outstanding stock thereof, to Petroleum Midway Company, Ltd. in consideration of a contract dated January 9, 1918, wherein Thomas A. O'Donnell, Petitioner herein, is designated first party and Petroleum Midway Company, Ltd., second party, which, among other things, obligated the Petroleum Midway Company, Ltd. [R. p. 39] to pay to Petitioner one-third of the net proceeds derived from the operation of the properties owned by the San Gabriel Petroleum Company.

On January 7, 1918, the Petroleum Midway Company, Ltd. exercised the option to purchase the stock from M. L. McCray and L. A. McCray and entered into a contract agreeing to pay them the amounts specified in said option; after January 9, 1918, and prior to May 1, 1918, the Petroleum Midway Company, Ltd. acquired all of the assets of the San Gabriel Petroleum Company which consisted of the leases transferred to it by the three parties aforementioned and assumed all of the obligations of the San Gabriel Petroleum Company which was thereafter dissolved; during the period from January 9, 1918, to July 25, 1919, the Petroleum Midway Company, Ltd. paid the Petitioner the total sum of $64,775.48 under and pursuant to the terms of said contract dated January 9, 1918.

On or about the 25th of July, 1919, Petitioner created by a written instrument, a declaration of

trust, wherein he appointed the Security Trust and Savings Bank as trustee, and assigned to it all of his right, title and interest in and to said contract; from the 25th of July, 1919, to and including December 31, 1922, the Petroleum Midway Company, Ltd. paid to Security Trust and Savings Bank as trustee under that declaration of trust No. 5106 the total sum [R. p. 40] of $348,896.66, by virtue of the contract of January 9, 1918.

During the year 1923 Security Trust and Savings Bank, as trustee in that certain trust No. 5106, received the sum of $32,080.85 from the Petroleum Midway Company, Ltd. by virtue of the contract of January 9, 1918, and the bank paid to itself as trustee commissions and fees in the sum of $320.81 and distributed during said year to the following persons the amounts set opposite their respective names:

Lillie O'Donnell	$ 3,000.00
Ruth O'Donnell Tompkins	750.00
Doris O'Donnell	750.00
Mamie Litster	900.00
O'Donnell Oil & Securities Co.	26,360.15
Total	$31,760.15

On April 9, 1923, said trust No. 5106 was revoked and on April 16, 1923, Petitioner created another trust known as No. 5549 wherein Security Trust and Savings Bank was appointed trustee and to which was assigned by Petitioner all his right, title and interest in and to said contract of January 9, 1918. During the balance of the year 1923 said trustee under trust No. 5549 received the sum of $83,984.08 from Petroleum Midway Company, Ltd. by virtue of

said contract of January 9, 1918, and after paying to itself as trustee commissions and fees [R. p. 41] in the sum of $839.88, said trustee distributed to the following persons the amounts set opposite their respective names:

Lillie O'Donnell	$ 9,000.00
Ruth O'Donnell Tompkins	2,250.00
Doris O'Donnell	2,250.00
Mrs. Myra O'Donnell	900.00
Mrs. Winnie Tucker	900.00
Tompkins Investment Co.	67,848.16
Total	$83,148.16

Petitioner kept his accounts and reported his income for the taxable year 1923 on a cash receipts and disbursements basis. [R. p. 42.]

The Board of Tax Appeals in its opinion recognized that the issue raised by Respondent related to the determination of the value of the rights acquired by Petitioner under the contract of January 9, 1918, and held that Taxpayer's contractual rights had no value, but, nevertheless, attempted to establish the cost of the properties exchanged by Petitioner as consideration for said contract. This latter issue was not raised by the pleadings and no evidence was submitted to substantiate the cost to Petitioner of the stock or options, but the Board assumed that the cost thereof could not have exceeded the total amount received by the trustees prior to the year 1923.

ASSIGNMENTS OF ERROR RELIED UPON.

Petitioner relies upon all the assignments of error which are as follows:

1. The Board of Tax Appeals erred in holding that the income derived during the year 1923 by the Security Trust and Savings Bank as trustee under trusts Nos. 5106 and 5549 constituted taxable income to Petitioner.

2. The Board of Tax Appeals erred in holding that Petitioner derived taxable income, not reported in his income tax return, in the sum of $114,908.31.

3. The Board of Tax Appeals erred in entering its order on June 17, 1932, determining a deficiency in tax against Petitioner for the year 1923 in the amount of $39,731.98.

4. The Board of Tax Appeals erred in failing to include in its findings of fact all of the facts contained in the stipulation entered into by and between the parties hereto, through their respective counsel, and which stipulation contained all the facts received by the Board in support of Respondent's affirmative allegations.

5. The Board of Tax Appeals erred in determining that the fair market value of the stock of the San Gabriel Petroleum Company acquired by Petitioner on June 28, 1917, in exchange for his interest in certain leases, together with the cost on the dates acquired of the options on the remaining two-thirds of the stock of said company, was not in excess of $413,672.14.

6. The Board of Tax Appeals erred in failing to confine its findings of fact, opinion and decision within the allegations of the pleadings.

7. The Board of Tax Appeals erred in failing to find that the cost to Petitioner of his contract dated January 9, 1918, with the Petroleum Midway Company, Ltd. was in excess of $550,000.00.

LAW AND ARGUMENT.

I.

The Proceeds Derived by the Security Trust and Savings Bank as Trustee Under Trusts Nos. 5106 and 5549 Pursuant to the Contract of January 9, 1918, Do Not Constitute Taxable Income to Petitioner.

The question in this case is controlled by the provisions of the Revenue Act of 1921. Section 219 of that Act [Appendix page 39] specifically provided that the fiduciary shall be responsible for making the return of income for the estate or trust for which he acts. The Commissioner of Internal Revenue, through his legal department, during the year 1922, ruled that the income from revocable trusts was not taxable to the trustor and that such income was to be taxed in the same manner as income received by the trustee under irrevocable trusts. (Law Opinion 1102, C. B. I-2 p. 50; also So. L. Op. 146, C. B. I-2 p. 160.) The legal department, in making its ruling, adopted the common law rule to the effect that a trust even though revocable did not in anywise affect its validity; that the trust continued as such for all income tax purposes until the right of revocation was actually exercised. This ruling has never been revoked and it was in

effect at the time the original returns were filed by the Security Trust and Savings Bank under trusts Nos. 5106 and 5549 and also at the time the beneficiaries filed their returns for the year 1923.

The Security Trust and Savings Bank as trustee under trusts Nos. 5106 and 5549 filed a fiduciary return for the year 1923 wherein it was disclosed that the income had been distributed to the beneficiaries. These beneficiaries, in compliance with the Commissioner's rulings, in their income tax returns for the year 1923 reported the amounts distributed to them and paid taxes thereon. This much may be assumed. Despite the fact that the beneficiaries of these trusts have complied with the Commissioner's ruling and have paid taxes on the income, the Commissioner has not offered to refund the amounts so paid but is attempting now to collect the sum of $45,619.16. Justice would require the refunding of these taxes to the beneficiaries if this Honorable Court should determine that the moneys received by trusts Nos. 5106 and 5549 constitute taxable income to Petitioner.

It is respectfully submitted that the moneys received by trusts Nos. 5106 and 5549 during the year 1923 do not constitute taxable income to Petitioner. The trusts were valid, effectual and subsisted during this year. Petitioner did not receive any part of this money and, therefore, he is not chargeable with the tax thereon. To hold that the moneys received by the trustee under these two trusts belonged to Petitioner would be to ignore the very terms of the declaration of trust. There has been no question raised about the validity of these trusts and indeed no such question could be raised.

The United States Supreme Court has clearly recognized that title vests in the grantee, subject to be divested where the deed reserved the power of revocation, together with the power to appoint to other uses as the grantor might designate.

In the case of *Jones v. Clifton* (101 U. S. 225), where the powers reserved were to revoke in whole or in part and to transfer the property to any uses the grantor might appoint, and to such person or persons as he might designate, and to cause such uses to spring or shift as he might declare, the court said:

> "The power of revocation and appointment to other uses reserved to the husband in the deeds in question does not impair their validity or their efficiency in transferring the estate to the wife, to be held by her until such revocation or appointment be made."

In that case the grantor, then solvent, conveyed the property to his wife. He later became insolvent, and the plaintiff, his assignee in bankruptcy, sought to set aside these deeds, or to exercise the power of revocation. The Supreme Court held that the deeds vested the property in the grantee, and that the power of revocation did not pass to the assignee in bankruptcy, stating:

> "The title to the land and policies passed by the deeds; a power only was reserved. That power is not an interest in the property which can be transferred to another, or sold on execution, or devised by will. The grantor could, indeed, exercise the power either by deed or will, but he could not vest the power in any other person to be thus executed. Nor is the power a chose in action. It did not, therefore, constitute assets of the bankrupt which passed to his assignee."

In the case of *Schreyer v. Schreyer* (91 N. Y. Supp. 1065, affirmed by the Court of Appeals, 75 N. E. 1134), the court said:

> "Among the powers which may be reserved in a deed of trust is that of the right of revocation by the settler of the trust. In speaking of this question, it was said by Judge Finch: 'But few things are better settled than that the reservation of such a power is entirely consistent with the trust and does not work its destruction when the rights of creditors are not involved. (*Van Hesse v. MacKaye,* 136 N. Y. 114 (32 N. E. 615)) * * *.' The effect of the absolute power of revocation reserved by the settlor of the trust does not affect its validity * * *. The trust created was perfect in character and was capable of execution and, remaining unrevoked, they could have compelled the exercise of the powers contained therein for their benefit."

See, also:

Nichols v. Emery (Cal.) (41 Pac. 1089);
Hillman v. McWilliams (Cal.) (11 Pac. 659);
Van Hesse v. MacKaye (N. Y.) (32 N. E. 615);
Hiserodt v. Hamlett (Miss.) (20 So. 143);
Dickerson's Appeal (Pa.) (8 Atl. 64).

It has been settled by a long line of cases that on the death of the creator of a revocable trust the power of revocation is ended, and by the death, the possibility of the title being divested has been removed. Therefore, as the power ended with the death, there is nothing to pass to the heirs or the beneficiaries under the will.

Kelly v. Snow (Mass.), 70 N. E. 89;
Barlow v. Loomis, 19 Fed. 677;

Bowdoin College v. Merrett, 75 Fed. 480;
Kelly v. Parker (Ill.), 54 N. E. 615;
Stone v. Hacket (Mass.), 12 Grey 227;
Van Cott v. Prentice (N. Y.), 10 N. E. 257;
Van Hesse v. MacKaye (N. Y.), 32 N. E. 615;
Robb v. Washington and Jefferson College (N. Y.), 78 N. E. 359;
Brown v. Spohr (N. Y.), 73 N. E. 14;
Nichols v. Emery (Cal.), 41 Pac. 1089;
Schreyer v. Schreyer, 91 N. Y. Supp. 1065;
Russell's Executors v. Passmore (Va.), 103 S. E. 652.

See, also:

Perry on Trusts, Sec. 104.

The leading case on this question is that of *Stone v. Hacket* (Mass.) (12 Grey 227). In that case, one Kittredge had conveyed shares of stock to the plaintiff, in trust, to pay the income to Kittredge during his life and upon his death to divide the property among certain charities. Kittredge reserved the power to modify or revoke the trust. After his death, his widow claimed the stock, on the ground that the trust was void. The plaintiff brought a bill of interpleader to determine the validity of the trust. It was held that the trust was in all respects valid, and that the widow of the grantor had no rights in the stock. The court said:

> "It was suggested by the learned counsel for the widow that the donor never parted with his power or dominion over the property because he retained a right to annul or revoke the trust. But this seems to us quite immaterial. A power of revocation is

perfectly consistent with the creation of a valid trust. It does not in any degree affect the legal title to the property. That passes to the donee and remains vested for the purpose of the trust, notwithstanding the existence of a right to revoke it. If this right is never exercised according to the terms in which it is reserved, as in the case at bar, until after the death of the donor, it can have no effect on the validity of the trusts or the right of the trustee to hold the property.

"Nor are we able to see any force in the suggestion that the trust which the donor created in some of its features looked to a disposition of the property which was the subject of the gift after his death. We know of no principle of law which renders such a transfer of property *inter vivos* invalid. The entire *jus disponendi* was in the donor. Perhaps if there were any facts to show that the transaction was intended to be testamentary in its character, and was entered into for the purpose of evading the provision of law regulating the execution of last wills and testaments, there might be some ground for impeaching the validity of the conveyance and withholding the sanction of the court from the trusts which the donor intended to establish."

In *Nichols v. Emery* (Cal.) (41 Pac. 1089), a father conveyed to his son a certain estate upon a revocable trust. The trust was held effectual. In that case it is stated:

"Nor did the fact that the settler reserved the power to revoke the trust operate to destroy it, or change its character. He had the right to make the reservation, but the trust remained operative and absolute until the right was exercised in proper mode

> * * *. The fact that he reserved the right to revoke did not impair the trust, nor affect its character, since title and interest vested subject to divestiture only by revocation, and if no revocation was made, they became absolute."

In a recent case, *Sims v. Brown* (158 S. W. 624), the Supreme Court of Missouri discussed the effect of a power of revocation in a trust deed:

> "Such reservation of power is not inconsistent with the creation of a voluntary trust. 'The power of revocation may, however, be reserved and is perfectly consistent with the creation of a valid trust.' (Citing authorities.) In fact, courts of equity have always looked with suspicion upon voluntary trust or settlements which do not reserve a power of revocation."

The trust being valid and passing a present right and title to the property, it cannot legally be held that income arising therefrom belonged to Petitioner. Otherwise, the statute would impose an income tax upon income which was not received by the taxpayer. It would tax one person upon income received by another. The tax is imposed upon income "received or drawn by the recipient". (*Eisner v. Macomber*, 252 U. S. 189.) The income from this trust was not received or drawn by the Petitioner as creator of the trust.

The United States Board of Tax Appeals upheld the ruling of the Department contained in this Law Opinion 1102 (*Appeal of Stoddard*, 3 B. T. A. 79). The opinion of the Board of Tax Appeals was likewise upheld in the case of *Warden v. Lederer*, 24 Fed. (2d) 233. So far as

counsel have been able to ascertain there has only been one case which is contrary to the foregoing and that is the case of *Stoddard v. Eaton,* 22 Fed. (2d) 184. Congress, in the 1924 Act, specifically provided that the income of a revocable trust was to be taxed to the creator thereof. (Section 219 (h).) However, Congress made no attempt to make the act retroactive even though that could have been done constitutionally. It is believed that the foregoing provision of the Revenue Act of 1924 was an expression by Congress of a new purpose. Congress, in passing the Revenue Act of 1924, which became effective on June 2, 1924, certainly was cognizant of the Commissioner's ruling and in effect approved the correctness thereof by passing the Act. The constitutionality of the provision of the Revenue Act of 1924 so far as it applies to trusts created prior to 1924 is now pending before the Supreme Court in the case of *Smith v. Reinecke,* 61 Fed. (2d) 324.

We do not need to go into these constitutional questions because, as heretofore pointed out, the Revenue Act of 1921 did not provide for the taxing of the trustor of the income received by a revocable trust. Indeed, the provisions of Section 213 of the Revenue Act of 1921 are specific in requiring the inclusion in gross income of "gains, profits, and income *derived* * * *". The use of the word "derived" makes it clear that Congress intended only to levy a tax against the taxpayer upon income derived. This language obviously excludes from gross income that income which is not derived. The Taxpayer in the instant case certainly did not derive the income in question which was paid to the trustee and by it distributed to the beneficiaries of the trust. The Board of Tax

Appeals was, therefore, in error in holding that the Petitioner was subject to tax upon the income in question.

Just why the Commissioner of Internal Revenue would attempt to repudiate his own rulings at this late day is not easy to understand unless it be the ever pressing need for revenue. No matter what the revenue needs may be, there is no justification for the Commissioner attempting to legislate. He should administer the law as he finds it. The Commissioner's rulings should be a haven of security for those taxpayers who relied thereon. To repudiate his rulings without attempting to refund the money collected because of a compliance therewith offends good conscience.

II.

The Issue Decided by the Board Was Not Raised by the Pleadings and the Facts in the Record Do Not Support the Board's Decision That the Moneys Received by the Trustee Constitute Taxable Income to Petitioner.

The record does not disclose what part, if any, of the proceeds derived by the Security Trust and Savings Bank under trusts Nos. 5106 and 5549 during the year 1923 constituted taxable income and what part capital. To prove that the amount of money received by the Security Trust and Savings Bank under trusts Nos. 5106 and 5549 in 1923 constituted taxable income to Petitioner, the Respondent proceeded on the theory that the transfer by Petitioner of his stock in the San Gabriel Petroleum Company and certain options on other stock of that company in consideration for the contract of January 9, 1918, was a completed transaction and that the cost to Petitioner of

his rights under the contract represented the fair market value on January 9, 1918, of Petitioner's rights therein. In his second amended answer Respondent specifically alleges that "the fair market value, if any, of the rights acquired by the Petitioner by virtue of the contract entered into between the Petroleum Midway Company, Ltd. and the Petitioner herein, on January 9, 1918 * * * did not exceed the sum of $75,000.00 on the last named date".

Practice Rule 30 of the Board of Tax Appeals specifically places the burden of proof on the Respondent in those cases wherein he affirmatively alleges facts tending to increase the deficiency from which the appeal was originally taken.

It is elementary that parties litigant are limited to the issues raised in the pleadings and that judicial and quasi-judicial bodies may not depart therefrom.

The only evidence offered by Respondent was the income tax return of Petitioner and a stipulation of facts, the substance of which is as follows:

> In March, 1917, Petitioner, M. L. McCray and L. A. McCray acquired for a nominal consideration certain oil and gas leases on land located in Los Angeles County, California. Thereafter and on June 28, 1917, Petitioner, M. L. McCray and L. A. McCray transferred and assigned these oil and gas leases to the San Gabriel Petroleum Company in exchange for its outstanding capital stock, Petitioner, M. L. McCray and L. A. McCray each receiving one-third of said stock.
>
> During the month of December, 1917, Petitioner acquired certain options to purchase all of the said stock in the San Gabriel Petroleum Company owned

by M. L. McCray and L. A. McCray. On January 9, 1918, Petitioner entered into a contract with the Petroleum Midway Company, Ltd. which provided among other things:

1. That the Petroleum Midway Company, Ltd. would acquire all of the assets of the San Gabriel Petroleum Company and would dissolve it.

2. That the Petroleum Midway Company, Ltd. would pay all the debts and liabilities of the San Gabriel Petroleum Company and would transfer such sum or sums of money as would from time to time be necessary to carry on the development of the oil properties then owned by the San Gabriel Petroleum Company.

3. That the San Gabriel Petroleum Company was to pay Petitioner at the time specified in said agreement one-third of the net proceeds received by it from the development and operation of the properties enumerated in the leases and contracts owned by the San Gabriel Petroleum Company.

4. That the Petroleum Midway Company, Ltd. exercised the options assigned to it by Petitioner and then entered into written agreements with M. L. McCray and L. A. McCray, in which agreements the Petroleum Midway Company, Ltd. bound itself to protect the two McCrays against stockholders' liability and also obligated Petroleum Midway Company, Ltd. to fulfill their leasehold obligations. Under the leases originally acquired by the McCray brothers they were obligated at their own expense to carry on extensive drilling operations.

5. On the 25th day of July, 1919, Petitioner, by a written declaration of trust, known as trust No. 5106, appointed the Security Trust and Savings Bank

as trustee and transferred to it, among other things, his contract with Petroleum Midway Company, Ltd., dated January 9, 1918. The declaration of trust provided, among other things, that:

(a) $1,000.00 per month should be paid to Petitioner's wife until she died and thereafter $1,000.00 per month should be paid to the O'Donnell Oil & Securities Company, a corporation.

(b) $250.00 to Petitioner's daughter Ruth.

(c) $250.00 to Petitioner's daughter Doris.

(d) $300.00 to Petitioner's sister Mamie Litster.

In the event of the death of Ruth O'Donnell, Doris O'Donnell and Mamie Litster, then the amounts to be paid to them should be paid to the O'Donnell Oil & Securities Company.

The balance of the undistributed net income and royalties was to be paid to O'Donnell Oil & Securities Company.

Petitioner, under the declaration of trust, was given the right of revoking it at any time after two years from its date. Petitioner, on April 9, 1923, exercised the right of revocation and did revoke this trust and created trust No. 5549, the Security Trust and Savings Bank being the trustee which acquired all of the assets of trust No. 5106. The beneficiaries under this latter trust were Petitioner's wife, his two daughters, and Mrs. Myra O'Donnell and Mrs. Winnie Tucker. The Tompkins Investment Company, a corporation, was made beneficiary in place of the O'Donnell Oil & Securities Company.

During the period from January 9, 1918, to July 25, 1919, Petroleum Midway Company, Ltd. paid to the Petitioner the total sum of $64,775.48 under and pursuant to the terms of the contract dated January

9, 1918. From the 25th day of July, 1919, to and including December 31, 1922, Petroleum Midway Company, Ltd. paid to the Security Trust and Savings Bank as trustee under trust No. 5106 the total sum of $348,896.66 pursuant to the contract of January 9, 1918.

During the year 1923 the Security Trust & Savings Bank, as trustee under trust No. 5106, received the sum of $32,080.85 and during the year 1923 the Security Trust and Savings Bank, as trustee under trust No. 5549, received the sum of $83,984.08 from the Petroleum Midway Company, Ltd., pursuant to said contract of January 9, 1918.

The Board of Tax Appeals in its opinion recognized that the issue raised by the pleadings was the fair market value of the rights acquired by Petitioner by virtue of the contract of January 9, 1918, and concluded that the fair market value of these rights could not be ascertained. Having determined that these rights had no fair market value, the Board of Tax Appeals then ought to have entered judgment for Petitioner. Despite the fact that no issue was raised by Respondent in his pleadings nor in his brief regarding the cost to Petitioner of the stock of the San Gabriel Petroleum Company and the options transferred in exchange for the contract of January 9, 1918, the Board of Tax Appeals inferred from the stipulated facts that the cost of these properties to Petitioner was not in excess of $413,672.14—the amount that had been paid pursuant to the contract prior to December 31, 1922. There is absolutely no evidence in the record which in any wise could be considered competent for the purpose of proving the cost to Petitioner of these prop-

erties; furthermore, this question was not in issue. The Board recognized that there was no such evidence and based its opinion entirely upon inferences. The Board, in its opinion, stated:

> "The record in this case is incomplete in many respects. The facts were stipulated and we have no opinion evidence such as is usually presented in valuation cases. * * * Though it is impossible on the record to determine exactly the fair market value of Petitioner's stock on June 28, 1917, we are satisfied that it, together with the cost of the options, was less than $413,672.14, * * *."

To determine the cost to Petitioner of his stock in the San Gabriel Petroleum Company as well as the cost of the options obtained from the McCray brothers, the Board assumed that it had to go back to the date when the stock was acquired, to-wit, June 28, 1917. Of course, when Petitioner and the McCray brothers transferred their leases, on June 28, 1917, to the San Gabriel Petroleum Company in exchange for its stock, the transaction was a taxable transaction. In determining the cost to Petitioner of his stock in the San Gabriel Petroleum Company, it would be necessary to determine the fair market value of all of the assets acquired by that company. The Board of Tax Appeals stated in its opinion:

> "Since all of the stock was exchanged for the leases and there being no evidence of any other assets, we believe it reasonably inferable that the stock had no greater value than the leases."

It is true there is no evidence showing what other assets were acquired but neither is there evidence to show the

contrary, that is, that there were no other assets. The Respondent had the burden of proof and it was up to him to prove exactly just what assets were acquired by the San Gabriel Petroleum Company. Another unsupportable assumption that the Board made was in assuming that the stock had no greater value than the leases when the leases were acquired. The Board stated:

> "The facts do not indicate that any development had been undertaken or production achieved prior to June 28, 1917, when the leases were transferred to San Gabriel Company."

This assumption is entirely unwarranted. The Board overlooked the fact that this question was not at issue and furthermore, that if it was, the burden of proof was upon the Respondent. The facts show that the oil and gas leases were acquired by Petitioner and the McCray brothers in 1917. These leases although acquired in March, 1917, for a nominal consideration, might have had a substantial value. There is nothing in the record to show that there had been no development; neither is there anything in the record to show that no production had been achieved prior to June 28, 1917. Instances are numerous where leases are acquired for a nominal consideration and in a very short time—almost over night—they become of tremendous value. This fact, so common in California, was evidently overlooked by the United States Board of Tax Appeals. It is more reasonable to assume that because of the formation of the San Gabriel Petroleum Company and the lapse of three months that the leases became of enormous value, than it was for the Board to assume that no development had been under-

taken or production achieved and that, therefore, the leases had no greater value at the time of the organization of the corporation than they did when acquired. Particularly is this true when consideration is given to the fact that the burden of proof was upon the Respondent, and that doubts in tax matters are to be resolved in favor of taxpayers.

If the fair market value on June 28, 1917, of the stock acquired by Petitioner was properly an issue in the case, then certainly the Respondent had the burden of proving its value; he had the burden of proving to the Board just what assets the San Gabriel Petroleum Company acquired, what indebtedness it assumed, the condition of the land covered by the leases, that is, whether or not it was in a proven area or in an area underlaid with oil and what development on or near the properties had been made between March, 1917, and June 28, 1917. He must also prove the fair market value of the land; he must also prove what relation the land had to other oil producing land on June 28, 1917, and what the prospects were for oil. The Commissioner would have to do just what a taxpayer would have been compelled to do, that is, prove all the facts necessary to show what the actual value of all of the assets was at the time acquired by the San Gabriel Petroleum Company. This the Respondent failed to do and, therefore, he did not sustain his burden of proof. Consequently, the Board's conclusion that the entire sum or any portion thereof received by the Security Trust and Savings Bank under trusts Nos. 5106 and 5549 is erroneous.

Furthermore, the Board erroneously assumed that the net price of $75,000.00 paid to each of the McCrays for

their stock in the San Gabriel Petroleum Company was indicative of the fair market value of the stock on June 28, 1917. Of course, the $75,000.00 paid to each of the McCrays was not the only consideration given by the Petroleum Midway Company, Ltd. The Petroleum Midway Company, Ltd., assumed all the obligations of the San Gabriel Petroleum Company, and furthermore, specifically agreed to save harmless the McCrays from their leasehold covenants and also from their liability as stockholders of the San Gabriel Petroleum Company. What the liabilities of the San Gabriel Petroleum Company were at the time its assets were acquired by the Petroleum Midway Company, Ltd. were not shown by the Respondent. The leases disclose that the covenants of the leases which were assumed by the San Gabriel Petroleum Company were of no small undertaking. These covenants, among others, required the carrying on of extensive drilling and development programs. Furthermore, there is nothing in the record to indicate the real considerations paid or undertaken to be performed by Petitioner or his assignee, the Petroleum Midway Company, Ltd. The mere fact that one of these options recited no consideration and the other a dollar consideration certainly is of no evidentiary importance. Some of the most valuable documents, including deeds, merely recite a nominal consideration.

The Board of Tax Appeals recognized that it was deciding the case on mere assumptions and inferences. In its opinion it is specifically stated:

> "The record in this case is incomplete in many respects. The facts were stipulated and we have no opinion evidence such as is usually presented in valuation cases. * * * Though it is impossible on

> the record to determine exactly the fair market value of Petitioner's stock on June 28, 1917, we are satisfied that it, together with the cost of the options, was less than $413,672.14, the amount paid on account thereof by Midway Company prior to January 1, 1923, * * *."

The inconsistency of the opinion of the United States Board of Tax Appeals is further demonstrated by its refusal in determining the only issue presented to it on the pleadings (the fair market value as of January 9, 1918, of the contract received by Petitioner) to employ as a basis for the determination of such value subsequent profits. The Board says:

> "Nor do we deem it proper to find a fair market value as of January 9, 1918, by employing as a basis the subsequent profits."

Despite this statement the Board of Tax Appeals, in endeavoring to draw unwarranted assumptions and inferences from the facts to establish the fair market value of the stock on June 28, 1917, not only took into consideration income subsequently derived under and pursuant to the contract but took into consideration only portions of events occurring at the time of the acquisition by Petitioner of the options.

The Board of Tax Appeals in innumerable cases has ruled against taxpayers where they have failed to establish values by competent evidence. The Board in numerous cases has refused to establish values by mere inferences and assumptions.

Apparently the Board of Tax Appeals fell into error in this case because its theory differed from the Commis-

sioner's theory. The Board believed that the value of the stock of the San Gabriel Petroleum Company at June 28, 1917, plus the cost of the options secured by Petitioner from the McCrays, represented the basis for the Petroleum Midway Company, Ltd. contract. The Commissioner, on the other hand, believed that the value of the Petroleum Midway Company, Ltd. contract at January 9, 1918, constituted its basis and framed his pleadings accordingly. He attempted to support the affirmative allegation in his answer by the facts stipulated. Neither party to the proceeding introduced any evidence as to the value of the stock of the San Gabriel Petroleum Company nor the cost to the Petitioner of the options on the McCrays' stock. Under these circumstances, the Board having found that the Petroleum Midway Company, Ltd. contract of January 9, 1918, had no fair market value, it should have rendered judgment for the Petitioner. Instead of this it attempted to make a finding of value when, as stated above, neither party had introduced evidence to prove such value. From this it is quite apparent that the taxes have not been properly determined by the Board of Tax Appeals.

We do not believe there is sufficient evidence in the record for the Board of Tax Appeals to conclude that Petitioner's interest in the contract of January 9, 1918, did not have a fair market value. There is no evidence to show that a reasonable estimate could not have been made of the proceeds expected to be derived under the contract. There is nothing in the record to show that the obligation on the part of the Petroleum Midway Company pursuant to the contract was a mere promise to Company, Ltd. pursuant to the contract was a mere

promise to pay an indeterminate sum. There is nothing in the record to show that the Petroleum Midway Company, Ltd. did not have other land in the vicinity of the land it acquired by virtue of the leases from the San Gabriel Petroleum Company. There is nothing in the record to show that on January 9, 1918 the lands covered by the leases acquired by Petroleum Midway Company, Ltd. from the San Gabriel Petroleum Company had not been proven and were not within the heart of a thriving oil field. There is nothing in the record to show or even to raise the inference that said contract did not have a reasonable fair market value. It is true the Supreme Court in the case of *Burnet v. Logan,* 283 U. S. 404-414, 75 L. Ed. 1143, held that a promise to pay indeterminate sums of money is not necessarily taxable income. The facts in that case are entirely different from the facts in the case at bar. Petitioner in this case, unlike the taxpayer in the Logan case, was one of the original lessees. He was under lease covenants to develop the property. He obtained a depletable interest in the oil property. His assignment of his interest in the leases to the San Gabriel Petroleum Company and its assignment to the Petroleum Midway Company, Ltd. did not deprive him of the right to depletion.

Palmer v. Bender, decided January 9, 1933, No. 215, unreported to date.

In this case two partnerships, of which taxpayer was a partner, acquired some oil leases on land in Louisiana and thereafter "assigned, sold and transferred" them to operating oil companies, the partnerships retaining a right

to receive a share of the oil and gas when produced. The Commissioner of Internal Revenue took the position that since the taxpayer and his other partners merely had an overriding royalty interest in the property, they having sold and assigned their lease, that they did not have a depletable interest and therefore refused to allow a deduction for depletion. The Supreme Court held that:

> "The language of the statute is broad enough to provide, at least, for every case in which the taxpayer has acquired, by investment, any interest in the oil in place, and secures, by any form of legal relationship, income derived from the extraction of the oil, to which he must look for a return of his capital.
>
> * * * * * * * *
>
> "Similarly, the lessor's right to a depletion allowance does not depend upon his retention of ownership or any other particular form of legal interest in the mineral content of the land. It is enough, if by virtue of the leasing transaction, he has retained a right to share in the oil produced. If so he has an economic interest in the oil, in place, which is depleted by production. Thus, we have recently held that the lessor is entitled to a depletion allowance on bonus and royalties, although by the local law ownership of the minerals in place, passed from the lessor upon the execution of the lease."

In view of the foregoing the payments made by the Petroleum Midway Company, Ltd., under the contract of January 9, 1918, to Petitioner and to his assignee, the Security Trust and Savings Bank, under trusts Nos.

5106 and 5549, were in fact royalty or rent payments; they were in fact payments of profits to one having a proprietary interest in the property from which the profits were derived. It would, therefore, naturally follow, that Petitioner and his assignee would be entitled to depletion deductions. Consequently, in no event would the entire sum received by the Security Trust and Savings Bank during the year 1923 be taxable income. The Respondent, in his second amended answer, considered it his burden to establish what part of the proceeds received by the Security Trust and Savings Bank, as trustee under the two trusts, constituted net taxable income to Petitioner. The sum of $114,908.38 representing what Respondent alleged in his answer as net income was not the gross income derived by the trustee under the contract. From the gross income were deducted certain expenditures as provided by Section 214(a) of the Revenue Act of 1921. While the Respondent recognized certain provisions of this section he failed to recognize the most important provision, that is, Section 214(a) (10) which allowed depletion deductions based upon cost or discovery value. The provisions of Section 214(a) (10) compel the Commissioner to allow these deductions. The Statute says, "in computing net income there shall be allowed" these depletion deductions. The Respondent having the burden of proving what part, if any, of this sum constitutes taxable income and having failed in that respect, the decision of the United States Board of Tax Appeals should be reversed.

SUMMARY.

Taxpayer believes the decision of the United States Board of Tax Appeals is entirely unwarranted and that it imposes upon him an unconscionable burden. It is respectfully submitted that the proposed assessment is arbitrary and capricious. Taxpayer, not having received the moneys derived by the two trusts, was not, under the Revenue Act of 1921, chargeable with taxes thereon. Taxes have already been paid, by the beneficiaries, on the proceeds derived by the trusts, all in accordance with the rulings of the Treasury Department. To now impose upon this Taxpayer the tax on the income he did not receive is to impose upon him a burden not contemplated under our taxing statutes. Before the Commissioner can conscientiously insist upon payment of this proposed assessment he should in good conscience refund the money collected on the income from the beneficiaries.

Arbitrary assessments and arbitrary proceedings relating thereto are not properly a part of our system of government. They tend to make insecure the property of taxpayers. Alexander Hamilton, in one of his papers (the Continentalist) stated:

> "* * * 'the genius of liberty reprobates everything arbitrary or discretionary in taxation. It exacts that every man, by a definite and general rule, should know what proportion of his property the state demands; whatever liberty we may boast of in theory, it cannot exist in fact while [arbitrary] assessments continue.' "

The foregoing quotation was taken from the case of *Pollock v. Farmers' Loan & Trust Company,* 157 U. S. 429, at p. 596.

The decision of the United States Board of Tax Appeals, it is most respectfully submitted, is based upon mere inferences and unwarranted assumptions. It had no competent evidence to determine value and, therefore, erroneously concluded that the Petitioner's contractual rights on January 9, 1918 had no value. The Board thereupon injected a new issue into the case and without evidence to support the cost of the property transferred by Petitioner, it determined a cost which resulted in the affirmation of the deficiency proposed by the Commissioner.

The law imposes the duty upon the Commissioner to correctly determine the tax; the Statute makes it mandatory on the Commissioner in determining net taxable income to deduct from gross income allowances for depletion of mineral properties. The Commissioner failed and the Board failed to comply with this mandate. The expressed duty was upon the Commissioner to determine net taxable income; this was his burden before the Board. That burden not having been met and there being no evidence on which the Board could determine Petitioner's net taxable income for the year 1923, the decision of the Board of Tax Appeals should be reversed.

It is a well established rule of law in cases of doubt in matters relating to taxation that those doubts should be resolved in favor of the taxpayer. This is a healthy

rule and one that has been recognized by the Supreme Court of the United States for a great many years. *Gould v. Gould*, 245 U. S. 151. Petitioner is not solely dependent upon this rule because the record shows conclusively, it is respectfully submitted, that the opinion of the Board of Tax Appeals is not supported by any competent evidence, consequently the decision of the Board of Tax Appeals should be reversed.

THOMAS R. DEMPSEY,
A. CALDER MACKAY,
Attorneys for Petitioner.

1104 Pacific Mutual Building, Los Angeles, California.

APPENDIX.

Revenue Act of 1921:

"Sec. 213. That for the purposes of this title (except as otherwise provided in section 233) the term 'gross income'—

(a) Includes gains, profits, and income derived from salaries, wages, or compensation for personal service (including in the case of the President of the United States, the judges of the Supreme and inferior courts of the United States, and all other officers and employees, whether elected or appointed, of the United States, Alaska, Hawaii, or any political subdivision thereof, or the District of Columbia, the compensation received as such), of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. The amount of all such items (except as provided in subdivision (e) of section 201) shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under subdivision (b) of section 212, any such amounts are to be properly accounted for as of a different period; * * *."

"Sec. 214. (a) That in computing net income there shall be allowed as deductions:

(1) All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, * * *.

* * * * * * * * *

(10) In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case, based upon cost including cost of development not otherwise deducted: *Provided,* That in the case of such properties acquired prior to March 1, 1913, the fair market value of the property (or the taxpayer's interest therein) on that date shall be taken in lieu of cost up to that date: *Provided further,* That in the case of mines, oil and gas wells, discovered by the taxpayer, on or after March 1, 1913, and not acquired as the result of purchase of a proven tract or lease, where the fair market value of the property is materially disproportionate to the cost, the depletion allowance shall be based upon the fair market value of the property at the date of the discovery, or within thirty days thereafter: *And provided further,* That such depletion allowance based on discovery value shall not exceed the net income, computed without allowance for depletion, from the property upon which the discovery is made, except where such net income so computed is less than the depletion allowance based on cost or fair market value as of March 1, 1913; such reasonable allowance in all the above cases to be made under rules and regulations to be prescribed by the Commis-

sioner, with the approval of the Secretary. In the case of leases the deductions allowed by this paragraph shall be equitably apportioned between the lessor and lessee."

"Sec. 219. (a) That the tax imposed by sections 210 and 211 shall apply to the income of estates or of any kind of property held in trust, including—

* * * * * * * * *

(4) Income which is to be distributed to the beneficiaries periodically, whether or not at regular intervals, and the income collected by a guardian of an infant to be held or distributed as the court may direct.

(b) The fiduciary shall be responsible for making the return of income for the estate or trust for which he acts. The net income of the estate or trust shall be computed in the same manner and on the same basis as provided in section 212, except that (in lieu of the deduction authorized by paragraph (11) of subdivision (a) of section 214) there shall also be allowed as a deduction, without limitation, any part of the gross income which, pursuant to the terms of the will or deed creating the trust, is during the taxable year paid or permanently set aside for the purposes and in the manner specified in paragraph (11) of subdivision (a) of section 214. In cases in which there is any income of the class described in paragraph (4) of subdivision (a) of this section the fiduciary shall include in the return a statement of the income of the estate or trust which, pursuant to the instrument or order governing the distribution, is distributable to each beneficiary, whether or not distributed before the close of the taxable year for which the return is made."